

IT 02-4

**Tax Type:** Income Tax

**Issue:** Audit Methodologies and/or Other Computational Issues

**STATE OF ILLINOIS  
DEPARTMENT OF REVENUE  
OFFICE OF ADMINISTRATIVE HEARINGS  
CHICAGO, ILLINOIS**

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**THE DEPARTMENT OF REVENUE  
OF THE STATE OF ILLINOIS,**

v.

**ABC, INC.,**

**Taxpayer**

No. 01-IT-0000  
FEIN 00-0000000  
Tax Year 1994

**Ted Sherrod  
Administrative Law  
Judge**

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**RECOMMENDATION FOR DISPOSITION**

**Appearances:** Special Assistant Attorney General Ralph Bassett on behalf of the Illinois Department of Revenue; Mark W. Russell, *pro se*, for ABC, Inc.

**Synopsis:**

This matter is before this administrative tribunal as the result of a timely protest by ABC, Inc. (hereinafter referred to as “taxpayer”) of the Illinois Department of Revenue’s Notice of Denial issued on March 30, 2001 for the 1994 tax year. The Department of Revenue (“Department”) has refused to accrue interest on overpaid tax for 1994 resulting from the allowance of an Illinois net loss deduction, from any date earlier than September 26, 2000. A pre-trial order was entered on October 1, 2001, in which the parties stated the issue to be decided as “whether the Department properly calculated

interest on overpaid tax from the date of September 26, 2000, or whether interest on this refund should have been calculated from an earlier date”. Prior to the commencement of hearing proceedings, the parties agreed to forgo an evidentiary hearing, and to litigate this matter through a stipulation and the presentation of briefs. Following a review of the documents of record, it is recommended that this matter be resolved in favor of the Department.

**Findings of Fact:**

1. The Department’s *prima facie* case against the taxpayer, inclusive of all jurisdictional elements, was established by the admission into evidence of the Notice of Denial dated March 30, 2001 denying the taxpayer’s refund claim for the tax year 1994. Stip. ¶ 1; Stip. Ex. 1.
2. ABC, Inc. (hereinafter “taxpayer”) is an Ohio corporation having its corporate offices at Anywhere, Ohio; the taxpayer is a wholly owned subsidiary of ABC of Sweden. Stip. Ex. 6.<sup>1</sup>
3. On April 21, 1997, the taxpayer filed a Form IL-1120-X, Illinois Amended Corporation Income and Replacement Tax Return, for the tax year ending 12/31/94 reporting a net operating loss (“NOL”) resulting from pre-12/31/86 federal changes of \$17,904,215; the net operating loss reported arose from “federal changes on federal amended return filed on 12/27/96” and “(C)hanges to federal NOL carryforward from years prior to 12/31/86 to conform to federal changes and previous state audit adjustments.” Stip. ¶ 3; Stip. Ex. 4; Stip. Ex. 6.

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<sup>1</sup> Unless otherwise noted, findings of fact apply to the tax year 1994.

4. On October 12, 1998, the taxpayer filed another form IL-1120-X, Illinois Amended Corporation Income and Replacement Tax Return for the tax year ending 12/31/94 reporting a net loss resulting from pre-12/31/86 federal changes in the amount of \$7,238,637; the net operating loss reported resulted from “(N)et operating loss carryforward from taxable year ended 3/31/86 not claimed on original return” and “(R)esearch and development credit generated in calendar year 1994 not claimed on original return.” Stip. ¶ 4; Stip. Ex. 5.
5. The Department’s auditor, Eileen Walker, audited the taxpayer’s original returns for tax years ended 12/31/91, 12/31/92 and 12/31/93, and audited taxpayer’s amended returns for 1994 filed in 1997 and 1998; however, the Department did not audit the taxpayer’s original 1994 return. Stip. ¶ 5; Stip. Ex. 6.
6. The auditor reduced the taxpayer’s federal adjusted gross income by \$22,426,572 for federal net operating loss carryforwards reported on the taxpayer’s amended returns for 1994 filed in 1997 and 1998. Stip. Ex. 10.
7. The auditor applied an Illinois net loss deduction (“NLD”) of \$1,551,750 resulting from Illinois net losses carried forward from 1991 and 1993 in arriving at the taxpayer’s net income for 1994. Stip. Ex. 6, 10.
8. On September 26, 2000, the taxpayer signed and filed an IL-870 for 1994; the taxpayer also signed amended returns for 1991 and 1993 showing Illinois net losses for these years. Stip. ¶ 8, 9, 11; Stip. Ex. 8, 12, 14.
9. The Department’s auditor determined that the Federal changes reported and the Illinois NLD completely eliminated the taxpayer’s tax for 1994 and produced a refund due the taxpayer in the amount of \$219,060; this refund was primarily the

result of the federal net operating losses reported by the taxpayer in 1997 and 1998, and the Illinois net loss deduction for losses carried forward from 1991 and 1993. Stip. Ex. 6, 10, 11.

**10.** The auditor determined that interest attributable to the taxpayer's federal NOL carryforwards that were applied to reduce the taxpayer's 1994 income tax liability began to accrue on October 8, 1995, the date on which the taxpayer's original return for 1994 was filed; the auditor also determined that interest attributable to the taxpayer's net loss deduction that was applied to reduce the taxpayer's 1994 income tax liability began to accrue on October 12, 1998, the date on which the taxpayer filed its second amended Illinois income tax return for 1994. Stip. Ex. 6, 10.

**11.** The Department subsequently revised the auditor's earlier audit findings to begin the accrual of interest attributable to the Illinois net loss deduction, on September 26, 2000, the date the taxpayer signed the IL-870 for 1994 and amended returns claiming an Illinois net loss for 1991 and 1993. Ex. 1,2,8,12,14.

**12.** The taxpayer filed an IL-1120-X form claiming additional interest due on the taxpayer's refund for 1994 on January 12, 2001; the Department denied the taxpayer's refund claim on March 30, 2001 and the taxpayer filed a protest of this refund claim denial on May 25, 2001. Stip. ¶ 1,2,12; Stip. Ex. 1,3,15.

### **Conclusions of Law:**

This matter is before this tribunal as a result of the Department's denial of the taxpayer's claim for refund of interest on overpaid taxes for the tax year 1994. The Department does not dispute that the taxpayer overpaid its 1994 Illinois Corporation

Income and Replacement Tax liability by \$219,060. Nor does it dispute that the taxpayer properly sought a refund of the overpaid taxes in its timely filed refund claims. The Department, rather, has refused to compute interest on a portion of this refund relating to Illinois net losses carried forward from 1991 and 1993 from the date of an IL-1120-X form amending the taxpayer's income reported for 1994, which was filed on October 12, 1998. The taxpayer contends that this amended return, and an amended return filed in 1997, constituted refund claims claiming an Illinois net loss deduction authorized by section 5/207 of the Illinois Income Tax Act ("IITA"), 35 ILCS 5/207.

Section 5/207 of the IITA, as in effect during the tax year in controversy, provides as follows:

- (a) If after applying all of the modifications provided for in paragraph (2) of Section 203(b), paragraph (2) of Section 203(c) and paragraph (2) of Section 203(d) and the allocation and apportionment provisions of Article 3 of this Act, the taxpayer's net income results in a loss, such loss shall be allowed as a carryover or carryback deduction in the manner allowed under Section 172 of the Internal Revenue Code.
- (b) Any loss determined under subsection (a) of this Section must be carried back or carried forward in the same manner for purposes of subsections (a) and (b) of Section 201 of this Act as for purposes of subsections (c) and (d) of Section 201 of this Act.

35 ILCS 5/207

Accordingly if, after applying all of the IITA's addition and subtraction modifications to federal taxable income and all of its allocation and apportionment provisions, the taxpayer's net income results in a loss, this loss will be allowed as an Illinois net loss carryback or carryover.

35 ILCS 735/3-2(d), which is section 735/3-2(d) of the Uniform Penalty and Interest Act ("UPIA"), 35 ILCS 735/3-1 *et seq.*, provides in part as follows:

Interest on amounts refunded or credited pursuant to the filing of an amended return or claim for refund shall be determined from the due date of the original return or the date of overpayment, whichever is later, to the date of payment by the Department without regard to processing time by the Comptroller or the date of credit by the Department or without regard to the date on which the credit is applied to the taxpayer's account. (Emphasis added)

35 **ILCS** 735/3-2(d)

The taxpayer's contention that interest on its NLD claim accrued from October 12, 1998 is based upon this section of the UPIA and on 86 Ill. Admin. Code § 100.9400 which indicates how the "date of overpayment" for purposes of computing interest on refunds is to be determined.

86 Ill. Admin. Code sec. 100.9400(c)(3)(C) provides as follows:

(C) In the case of a federal change due to the final allowance of a carryback or carryforward from a loss year ending on or after December 31, 1986, and in the case of an Illinois change due to the carryforward or carryback of an Illinois net loss ... the date of overpayment shall be the date the claim for refund is filed, except that if any overpayment is refunded within 3 months of the date the claim for refund is filed, determined without regard to processing by the Comptroller, no interest shall be allowed on such overpayment.

86 Ill. Admin. Code sec. 100.9400(c)(3)(C)

The taxpayer argues that, pursuant to this provision and 35 **ILCS** 735/3-2(d), interest on the taxpayer's refund for the tax year 1994 accrued from the date the taxpayer filed its amended return on October 12, 1998. It contends that this date should be treated as the date its claim for an NLD for 1994 was filed. The Department agrees that interest on refunds attributable to an Illinois net loss deduction is due from the date of the filing of an NLD refund claim as indicated by 86 Ill. Admin. Code sec. 100.9400(c)(3)(C). However, the Department does not agree that the taxpayer's IL-1120-X form filed in

1998 constituted a refund claim for the net loss deduction created by Illinois losses carried forward from 1991 and 1993.

The record indicates that, on April 21, 1997, the taxpayer filed an IL-1120-X reporting federal changes for 1994. The taxpayer indicated in Part V of this form that the purpose of this filing was to report “(C)hanges required to report federal changes on federal amended return filed on 12/27/96” and “(C)hanges to federal NOL carryforward from years prior to 12/31/86 to conform to federal changes and previous state audit adjustments.” Subsequently, the taxpayer filed an IL-1120-X on October 12, 1998 reporting additional federal changes for 1994. The taxpayer indicated in Part V of this form that the purpose of this filing was to report “(N)et operating loss carryforward from taxable year ended 3/31/86 not claimed on original return” and “(R)esearch and development credit generated in calendar year 1994 not claimed on original return.” The taxpayer made no reference to an Illinois net loss deduction in either of these amended returns. Moreover, the taxpayer did not attach a schedule NLD as required by the instructions to the IL-1120-X forms the taxpayer submitted.<sup>2</sup> Nor is there any entry on line 2 of Part IV of these forms, the space designated for reporting NLD, indicating that any NLD is being taken. In spite of these omissions, the taxpayer claims that its IL-1120-X forms filed in 1997 and 1998 should be treated as valid NLD refund claims for 1994. Stip. Ex. 3.

The taxpayer’s position is not supported by Illinois case law. In Dow Chemical v. Department of Revenue, 224 Ill. App. 3d 263 (1<sup>st</sup> Dist. 1991), the taxpayer timely filed its

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<sup>2</sup> The IL-1120-X Instructions for 1997 and 1998 governing the reporting of a net loss deduction (“NLD”) provide: “**You must attach an Illinois Schedule NLD or UB/NLD to support the amount of Illinois NLD claimed**”. IL-1120-X Instructions (R-12/97, R-12/98) at page 3.

1975 through 1978 tax returns. The Department audited these returns, proposed an additional liability and issued a Notice of Deficiency in December, 1979 which Dow timely protested. Subsequently, the parties determined that the case should be returned for a reaudit. The reaudit results were finalized in December, 1983 and revealed that the taxpayer had overpaid its Illinois tax liability with regard to the years in question. The taxpayer then filed a refund claim and requested that the overpayment be returned. The refund was denied; since the statute of limitations had expired for the years involved the claim was time barred and therefore improper. The Illinois Appellate Court, in finding in favor of the Department held that, although the Department had a duty to refund overpayments, the taxpayer had a duty to file proper claims to receive those refunds.

The record clearly indicates that the taxpayer failed to file proper refund claims claiming an NLD in this case.

Section 5/904(d) of the IITA, 35 **ILCS** 5/904(d), provides as follows:

Refund claim. Every claim for refund shall be filed with the Department in writing in such form as the Department may by regulations prescribe, and shall state the specific grounds upon which it is founded.

35 **ILCS** 5/904(d)

Section 904(d) of the IITA, 35 **ILCS** 5/904(d), indicates that only claims for refund filed in the form the Department's regulations prescribe can be considered proper refund claims. The Department, in turn, has promulgated 86 Ill. Admin. Code § 100.9400 which sets out the manner in which refund claims must be filed in order to constitute proper refund claims under Illinois law. The Department has indicated that form IL-1120-X is the proper vehicle for the taxpayer to file a refund claim in this case. 86 Ill. Admin. Code sec. 100.9400(f)(4),(5); IL-1120-X Instructions (R-12/97, R-12/98).



The instructions to form IL-1120-X elaborate upon the requirements that must be adhered to in order for a claim for overpayment to be a valid refund claim. These instructions have the force and effect of Department regulations pursuant to 35 **ILCS** 5/1401 and 35 **ILCS** 5/1501(a)(19).

Expanding upon the requirement set forth in 35 **ILCS** 5/904(d) that a proper claim for refund set forth the specific grounds upon which a refund is claimed, 86 Ill. Admin. Code sec. 100.9400(f)(1) states as follows:

Every claim for refund shall be in writing, shall be on the appropriate form prescribed by the Department, and (using attachments if necessary) shall state the specific grounds upon which it is founded.  
86 Ill. Admin. Code sec. 100.9400(f)(1)

It is evident from section 5/904(d) of the IITA, 35 **ILCS** 5/904(d), and 86 Ill. Admin. Code sec. 100.9400(f)(1) that the taxpayer in this case was required to file amended returns, with appropriate attachments, identifying the specific adjustments giving rise to a refund, and the reasons why these adjustments must be made. Moreover, as noted above, the instructions to form IL-1120-X make the attachment of a Schedule NLD to the amended return claiming an NLD a prerequisite to taking an Illinois net loss deduction. In spite of these requirements, the taxpayer's 1997 and 1998 amended returns contained no information apprising the Department that an NLD was being taken and no Schedules showing how the NLD was to be applied. Accordingly, the taxpayer's 1997 and 1998 amended returns did not meet essential statutory and regulatory requirements that must be met in order for a form IL-1120-X to be considered a claim for an NLD under the Illinois Income Tax Act.

The conclusion that the taxpayer's amended returns filed in 1997 and 1998 did not constitute proper refund claims for purposes of claiming an NLD fully comports with the important functions that refund claims perform under the IITA. The most obvious function performed by a refund claim is to apprise the Department of a taxpayer's position regarding a previously paid tax, thus initiating the Department's internal administrative review procedures. 35 ILCS 5/909. Such procedures facilitate a prompt and efficient review of the claim's merits, and give the Department an opportunity to resolve any tax controversy arising from the claim without the need for litigation. A second function performed by the refund claim is to govern the taxpayer's right to pursue recovery through litigation. 35 ILCS 5/910. The merits of the taxpayer's claim form the legal basis for such appeals and control the amount of overpaid tax the taxpayer is entitled to recover if litigation is successful. Obviously, neither of the important functions a refund claim is designed to perform under Illinois law can be achieved if the claim does not apprise the Department of the basis for the taxpayer's claim. Accordingly, documents that seek to function as a claim but that do not identify the specific grounds upon which the claim is based cannot be treated as a valid refund claim under Illinois law.

Moreover, the record shows that the taxpayer had no basis for claiming an Illinois NLD in 1997 and 1998. A prerequisite to taking an NLD is a determination that the taxpayer has an Illinois net loss to carry forward. 35 ILCS 5/207. In this case, it was essential that the taxpayer's Illinois net loss for 1991 and 1993 be identified before an NLD could be claimed since the NLD in this case was based upon Illinois net losses in these years. However, the record shows that the taxpayer did not finalize its IL-1120-X

amended returns reflecting the existence of a 1991 and 1993 Illinois net loss until September 26, 2000. To allow the taxpayer to take an NLD for 1994 would permit the application of net loss carryforwards from 1991 and 1993 prior to the date on which the existence of net losses for these years was clearly identified. Taking an NLD in this manner is clearly precluded by the conditions imposed upon the allowance of this deduction by the instructions to form IL-1120-X requiring that a schedule NLD, identifying the precise nature of the NLD being claimed, be attached to this form.

The Department has computed interest on the NLD for 1994 to accrue from September 26, 2000, the date the IL-870 was signed.<sup>3</sup> The taxpayer contends that computing interest in this manner violates 86 Ill. Admin. Code sec. 100.9400(c)(3)(C) because treating an IL-870 as a refund claim is not authorized by the Department's regulations. As noted earlier, this section of the regulation provides that interest on an NLD must be computed from the date that a claim for refund claiming the NLD is filed. The taxpayer argues that an IL-870 cannot be treated as a claim for refund pursuant to this provision. However, as pointed out in the Department's brief, the form IL-870 signed by the taxpayer expressly states that: "(T)his waiver constitutes a valid claim for refund or credit of overpayment if it is properly signed and filed within the period established by law for making such claim." (Emphasis supplied). Dept. Brief at page 6.

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<sup>3</sup> An IL-870 "Waiver of Restrictions" is a non-binding agreement; the form expressly states that "(T)his waiver is not a binding determination and does not preclude assertion of a further deficiency in the manner provided by law if it is later determined that additional tax is due..". Although the IL-870 the taxpayer signed on September 26, 2000, was based on an understanding reached with the Department's auditor that interest would accrue from a date prior to September 26, 2000, the Department was not bound by this determination.

Accordingly, the Department properly treated the IL-870 as a refund claim for purposes of applying 86 Ill. Admin. Code sec. 100.9400(c)(3)(C) in this case.<sup>4</sup>

The taxpayer, in the last two unnumbered pages of its brief, also argues that the effect of NOL carryforwards and the Illinois NLD on the taxpayer's 1994 income tax return are cumulative, and that therefore an NOL claim should be treated as the "alter ego" of an NLD claim. However, the record in this case clearly indicates that federal NOL carryforwards and the Illinois net loss deduction were computed and applied separately in arriving at the taxpayer's 1994 income tax liability. Stip. Ex. 2. Moreover, the taxpayer's argument misconstrues the legislative intent of 35 **ILCS** 5/207, which enacted the Illinois NLD into law in 1985 as P.A. 84-1042, § 1, eff. Nov. 26, 1985. The legislature clearly intended to decouple the Illinois NLD from the computation of the federal NOL when it passed this legislation. This is clear from the plain language of 35 **ILCS** 5/207 authorizing an NLD, which is drafted to deliberately avoid "piggybacking" upon Federal NOL carryforwards and carrybacks. Thus, 35 **ILCS** 5/207 expressly incorporates by reference 35 **ILCS** 5/203(b)(2)(D) which provides that "(T)he amount of any net operating loss deduction taken in arriving at taxable income, other than a net operating loss carried forward from a taxable year ending prior to December 31, 1986" shall be added back in computing an Illinois net loss deduction.<sup>5</sup> *See also* Illinois Department of Revenue Information Bulletin FY88-1, 07/00/1987.

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<sup>4</sup> While 86 Ill. Admin. Code sec. 100.9210, mentioned in the taxpayer's brief, discusses the use of form IL-870 to waive restrictions on assessments in accordance with 35 **ILCS** 5/907, this regulation does not address whether an IL-870 constitutes a refund claim. However, the characterization of this form as a "refund claim" in the text of this form is sufficient to make this form a refund claim under the Department's regulations. 35 **ILCS** 5/1401; 35 **ILCS** 5/1501(a)(19).

<sup>5</sup> An addition modification is also required for any tax year in which net operating loss carryback or carryforward from a tax year ending before 12/31/86 is an element of taxable income. 35 **ILCS** 5/203(b)(2)(E).

Moreover, the requirements for taking an NLD indicated in the instructions to form IL-1120-X are entirely different from the requirements that apply to an NOL carryforward. As noted above, form IL-1120-X return instructions clearly require that a Schedule NLD be filed in order to take an Illinois net loss deduction. These instructions also indicate that a taxpayer seeking to carry forward a federal NOL must file an entirely different attachment, Schedule NL-5g. *See* Instructions to IL-1120-X, Part I, line 5C. Thus, 35 **ILCS** 5/207 and the return instructions clearly indicate that an IL-1120-X claiming an NOL carryforward and an IL-1120-X claiming an Illinois NLD cannot be treated as one and the same.

The record indicates that the Department's auditor initially treated the taxpayer's October 12, 1998 amended return as an NLD claim, and accrued interest on the NLD from this date, because "the taxpayer intended" to carry forward net loss from 1991 and 1993, even though it did not actually do so when it filed its amended return. *Stip. Ex. 6.* However, the fact that the Department might have been aware that the taxpayer was entitled to an NLD was not a sufficient legal basis for applying the NLD at the time it could have been utilized in the absence of a timely NLD refund claim. The taxpayer had an affirmative duty to file its NLD claim before any such relief could be granted. Dow Chemical, *supra* at 267.

**WHEREFORE**, for the reasons stated above, it is my recommendation that the Department's Notice of Denial denying the taxpayer's refund claim for the tax year 1994 be upheld.

Ted Sherrod  
Administrative Law Judge

Date: February 1, 2002